No. 13,284

United States Court of Appeals

For the Ninth Circuit

MUTUAL TELEPHONE COMPANY (a corporation),
Appellant,

vs.

UNITED STATES OF AMERICA,
Appellee.

Appeal from the United States District Court for the District of Hawaii.

REPLY BRIEF FOR MUTUAL TELEPHONE COMPANY, APPELLANT.

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INTRODUCTION.

The amount involved in this case is $36,728.39 (plus interest), rather than $38,434.23 as stated on the first page of appellee's brief (R. 14, 28).

Appellee's brief makes two principal contentions in support of its argument that the District Court, below, did not err in holding that the increased installation and new supersedure charges were includable in appellant's taxable income in 1941 and 1942:

I. The increased charges in question were received by the taxpayer during the taxable years under a

claim of right and without restriction shown as to their use and disposition.

II. The increased charges in question clearly constituted taxable income to the taxpayer for the years 1941 and 1942, within the meaning of the Sixteenth Amendment.

In this reply brief we will answer these contentions and the arguments advanced in support thereof in that order.

ARGUMENT.

I. THE INCREASED INSTALLATION AND NEW SUPERSEDURE CHARGES RECEIVED BY APPELLANT FROM ITS SUBSCRIBERS IN 1941 AND 1942 WERE NOT TAXABLE INCOME TO IT IN THOSE YEARS BECAUSE SUCH CHARGES WERE RECEIVED AND HELD IN THOSE YEARS SUBJECT TO A RESTRICTION AND WERE NOT SUBJECT TO APPELLANT'S UNFETTERED COMMAND.

The principal point at issue here is relatively simple—does the order of the Public Utilities Commission requiring appellant to segregate and retain in a liability or suspense account the amount of the increased charges collected from subscribers in 1941 and 1942 constitute a "restriction" as to the disposition thereof within the rule of *North American Oil Consolidated v. Burnet,* 286 U.S. 417?

It is our contention (Appellant's Brief 14, 22-26, 43) that the order of the Commission was a "restriction" which deprived appellant of the "unfettered command" over the amount credited to subaccount 175.2 and prevented appellant from deriving any

"readily realizable economic value" therefrom (*Corliss v. Bowers,* 281 U.S. 376, and *Rutkin v. United States,* 343 U.S. 130). The order was admittedly binding on appellant and the effect of it was to require appellant to keep on hand at all times in cash or marketable securities an amount equal to the amount credited to subaccount 175.2 which could be paid out for any purpose the Commission might direct. It cannot be denied that this was the practical effect of the Commission's order. The likelihood or remoteness of the possibility that appellant would be ordered by the Commission to repay the charges is not the significant point—the fact is that until the Commission entered a *final* order in 1949, appellant was in a state of suspense with respect to these charges and as a regulated public utility was obliged to have an equivalent amount on hand to pay out as the Commission might direct. The Commission's order was not something which could be complied with by a mere bookkeeping entry; it was a real restriction which required appellant to keep equivalent funds or securities on hand and in effect deprived appellant of any economic value it might otherwise have derived from the increased charges. *North American Oil Consolidated* and other taxpayers which received funds without restriction but which might subsequently have to be repaid could have paid out all their cash as dividends or for other corporate purposes without violating any order of a regulatory body or court; if appellant had done so it would have failed to comply with the obvious intent and purpose

of the Commission's order. In order to determine the meaning of the Commission's order it is only necessary to look at the Commission's action in 1948, when it directed transfer of $41,970.50 in cash (appellant having been "ordered to maintain this amount in Account No. 175.2 until further directed") to the "pension reserve" (R. 75-77 and footnote 3, p. 75). The Commission would certainly have considered it a violation of its order if appellant had replied that it could not transfer this cash because it had considered the order merely a "nicety of accountancy technique" or "jargon of bookkeeping" (Appellee's Brief, 16) and although it had set up the amount in subaccount 175.2 it had actually spent all its cash and marketable securities and had no funds left available to transfer to the pension reserve.

Appellee's brief ignores the practical effect of the Commission's order on appellant and relies on the fact that the physical moneys collected under the increased charges were used by appellant without regard to source to establish its contention that the Commission's order did not place any restrictions whatever on appellant's use and command of the increased charges in 1941 and 1942 (Appellee's Brief 18-30). Appellee treats the segregation of the increased charges in subaccount 175.2 as a bookkeeping entry which did not alter the taxable status of such increased charges in the years received (Appellee's Brief 19-20-21).

To accept appellee's argument would be to ignore the actualities of what the Commission's order re-

quired appellant to do and what it did do. Appellant does not controvert our contention that if the Commission's order had required the physical funds collected from the increased charges to be deposited in escrow or locked up in a bank, they would not be income to appellant in 1941 and 1942 (Appellant's Brief 25, 31). The only difference between this situation and what actually happened is that the Commission's order permitted appellant to use the physical funds while requiring it to account for the same and keep an equivalent amount on hand. The result in this case should not turn upon such a technicality.

In this case, the Commission's order allowed appellant to collect the increased charges *provided* it segregated them in a separate account. Of the numerous cases cited in appellee's brief (18-39) only two involve a similar situation—that is, where the taxpayer is permitted to receive money but subject to a restriction imposed by a court, regulatory body or binding contract. These cases are *Comm'r v. Brooklyn Union Gas Co.,* 62 F. (2d) 505 (1933) and *Agne v. United States,* 42 F. Supp. 66 (1941).

The parties differ as to the correct interpretation of the *Brooklyn Union Gas* case (Appellant's Brief 38-40; Appellee's Brief 25-29). Appellee states that the Court of Appeals for the Second Circuit affirmed the Board and held that the excess charges were taxable income to the taxpayer for the years in which the services were rendered (Appellee's Brief 26). However, we believe that although the Second Circuit affirmed the order of the Board, it did so on the

ground that all of the excess charges (except for $673,000, discussed below) were income in the years withdrawn from impoundment, rather than in the years earned as the Board concluded. Thus, the Second Circuit states: "While this case [*North American Oil Consolidated v. Burnet*] casts doubt upon the correctness of the Board's theory that the excess moneys are to be allocated to the years, respectively, when the gas was sold, it strongly supports the decision that final termination of the litigation was not the critical moment" (p. 506). It should be remembered that to *affirm* the Board's order it was only necessary for the Second Circuit to hold that the money was *not* income in 1922 when the litigation terminated—it was not necessary to decide whether it was income when the gas was sold or when it was released from impoundment. We are satisfied that the Second Circuit concluded that *North American Oil Consolidated v. Burnet* required that the money (except for the $673,000) be considered income when released from impoundment. This being the case, the situation with respect to Rate Cases No. 1 is merely an application of *North American Oil Consolidated v. Burnet* as pointed out in our brief (38-40). There was no *restriction* when the moneys were released from impoundment except the giving of the taxpayer's own bond or the bond of the parent which owned 100% of the stock of the taxpayer (22 B.T.A. 510), which added nothing to the contingent liability the taxpayer was under regardless of the bond.

With respect to Rate Cases No. 2 and particularly the $673,000 not withdrawn from impoundment, the Second Circuit's opinion is confusing. The court order in Rate Cases No. 2 permitted the excess charges to be withdrawn upon the deposit of "approved securities" or the giving of a "surety bond" —in each instance surety bonds were given (22 B.T.A. 513). Apparently the majority considered that the giving of a surety bond was not a restriction because it did not "add anything to the contingent liability they were under regardless of such bonds" (p. 506). Judge Learned Hand, who dissented in part, did not agree with this—the requirement of giving approved securities or a surety bond, as distinct from the taxpayer's own bond, does not make the excess charges immediately available, like cash on deposit. "I do not see how such moneys are any more received by the taxpayers, than if the court continued to impound them" (p. 507). It seems to us that Judge Hand was right, that the requirement of giving a surety bond was a real restriction which should have prevented the excess charges from becoming income (see comment 2 Merten's Law of Federal Income Taxation, page 309, footnote 3).

With respect to the $673,000, the majority of the Second Circuit seems to have held that this was income in the years the gas was sold, even though not withdrawn from impoundment, principally because the entire cost of furnishing the gas was charged to the year when the service was rendered and to credit the revenue to another year would unfairly distort

the taxpayer's income (p. 507). We think that this portion of the decision is contrary to *North American Oil Consolidated v. Burnet* because the excess moneys were subject to a restriction when earned. Furthermore, this portion of the decision is not applicable to our case because a substantial portion of the expenses attributable to the increased charges was not charged off in the year the revenues from the installations and supersedures were received (R. 25, 26).

In the *Agne* case, majority stockholders in 1922 sold stock which they had purchased from the minority for an insufficient consideration. In the same year Stappenback and other minority stockholders brought actions claiming fraud on them. The bulk of the proceeds of the sale was received by the majority stockholders without any restriction but the "small amount" of $12,000 was by court order subjected to a trust to satisfy the possible outcome of the Stappenback litigation. The case was heard before five judges of the Court of Claims. Judge Madden, who wrote the opinion, held that the entire amount of the proceeds of the sale, including the $12,000, was income to the majority stockholders in 1922. One concurring judge, who wrote an opinion, thought it was wrong to hold that under the circumstances the taxpayer had received earnings under a claim of right with full power of control and disposition. "The exercise of any such power over a portion, at least, of such funds was prevented by court order made in 1922" (42 F. Supp. 73). Nevertheless, he concurred in the result because the taxpayer was not equitably entitled to

recover since he sought to benefit from an illegal transaction. Since the other three judges of the court did not join in Judge Madden's opinion but merely "concurred", it is impossible to tell how the majority of the court felt on the question of the receipt of the $12,000 as income not subject to a restriction.

Lykes Bros. S.S. Co. v. Comm'r, 126 F. (2d) 725, cited by appellee (Appellee's Brief, 29) might have involved the receipt of moneys subject to a binding restriction if the mail carriage contract had required a portion of the mail "subsidies" to be deposited in a special fund, but both the Board (42 B.T.A. 1395, 1403) and the Fifth Circuit (126 F. (2d) 727) expressly found that the mail carriage contract contained no such requirement, and the case turned on this point. There is certainly a strong implication in the opinion of the Fifth Circuit that if the mail contract had contained such a requirement, the funds received would have been so "earmarked or fettered as not to have been really received as income" (p. 727).

Appellee states that *Penn v. Robertson,* 115 F. (2d) 167, is "indistinguishable" from this case (Appellee's Brief, 24), but as we have pointed out (Appellant's Brief, 42) the taxpayer in that case was entirely free to take up his stock allotment at any time during the taxable year; when the bonuses and dividends were credited to his stock account there was nothing which prevented him actually receiving them except the exercise of his right to take up his stock allotment, which was within his own discretion. This case does

not illustrate receipt of money subject to a restriction which cannot be avoided by the recipient.

The parties are in disagreement as to the meaning of this court's language in *Baboquivari Cattle Co. v. Comm'r,* 135 F. (2d) 114 (Appellant's Brief 19-20; Appellee's Brief 20-21). That case held that payments by the United States to a ranching corporation under the Soil Conservation and Domestic Allotment Act were income rather than capital subsidies. The taxpayer of its own volition entered the payments on its books as capital items. This court said:

> "No part of the sums paid to the petitioner were required to be placed by him in a particular account or fund. The payments were not earmarked, nor was there any restriction on their use. Petitioner was free to use the money for any purpose it might see fit, as to defray operating expenses or to pay dividends or to purchase an automobile. Obviously, the manner in which the taxpayer entered the items on its books is of no moment." (p. 116)

In our brief (19-20) we have referred to this case as showing a recognition by this court that money received subject to the restriction that it must be placed and held in a particular account is not income. If this is not correct, why did the court use the language quoted above? If the court had thought that a requirement that money be placed in a particular account or fund is of no significance, it would hardly have used this language. Appellee contends (20-21) that the basis of the decision was that there was not

any restriction on the use of the moneys, "as here". True, there was no restriction on the use of the funds and the court's decision is clearly correct on this point. But in the case at bar, there was a restriction —appellant might have used the physical currency received from the increased charges "to defray operating expenses or to pay dividends or to purchase an automobile" but it had to credit an amount equal to such collections to subaccount 175.2 and keep an equivalent amount of cash or marketable securities on hand to comply with the Commission's order. There was no such restriction imposed by a regulatory public authority on the Baboquivari Cattle Company. We believe that the decision of this court in the *Baboquivari* case is decisive on the issue as to whether the increased charges were income in 1941 and 1942. Since they were required to be placed in a particular fund and earmarked and their use restricted, the court has only to refer to its language noted above from the *Baboquivari* case to sustain a decision that the increased charges were not income in 1941 and 1942.

Appellee appears to feel (Appellee's Brief 18-19) that the status of the increased installation and supersedure charges as income is in some way affected by the following language in the Commission's first decision:

> "The increase over present charges would be credited to Account No. 175, Contributions to Telephone Plant, and in computing rates on an 'investment basis' would be a reduction from the net investment in arriving at a rate base. Inves-

> tors would not require a return and subscribers would be spared paying a capital charge on same." (R. 46)

This provision was certainly of no benefit to appellant as it would have meant lower rates if a rate base determination had been made during this period—in fact, none was made until 1948 when the Commission ordered the amount in subaccount 175.2 transferred (R. 29-31, 75-78). The Commission's action in 1948 shows that its earlier ruling that the amount in subaccount 175.2 would be a reduction in net investment in arriving at a rate base was merely temporary, since upon the transfer of the amount in subaccount 175.2 to the "pension reserve" and the elimination of the account (R. 30-32) there remained nothing to deduct from net investment in arriving at a rate base. The references in appellee's brief (18-19, 22) to the fact that under the Commission's first decision "the subscribers" would not require a return on the amounts in subaccount 175.2 are erroneous. The decision was that *investors,* not subscribers, would not require a return. Investors in a public utility company are obviously not the same people as subscribers to its services, and subscribers to a utility certainly do not require a return on utility property. The Commission's language in its first decision, quoted above, does not mean that the subscribers would not require return to them of the increased charges, as appellee contends (Appellee's Brief, 22), but that the stockholders of Mutual Telephone Company would not re-

quire a rate of return on that portion of its utility property represented by the amount in subaccount 175.2.

Appellee insists (Appellee's Brief 18, 36) that appellant received the increased charges under a claim of right because they were collected under authorization by the Commission. However, although appellant claimed the right to collect the increased charges, it did not claim the right to *keep* them at the time they were collected (Appellant's Brief 20-21). In *Sohio Corporation v. Comm'r,* 163 F. (2d) 590, the taxpayer was clearly authorized by state law to collect the funds but it disclaimed any right to keep them and, therefore, was held not to have received them under a "claim of right". In the "claim of right" cases cited in appellee's brief (33-39) the taxpayer not only claimed the right to collect the money but also the right to keep it. As pointed out in our brief (20-21) appellant never claimed the additional charges were required as additional revenue and did not know whether it would be allowed to retain them or not. Prior to its petition to discontinue the increased charges in April, 1942, appellant made no attempt to establish any right to keep them (R. 56-57) and the Commission then rejected appellant's effort to "recapture" them (R. 60-61). Appellant's purpose in instituting the new charges would have been satisfied if they had deterred new telephone subscriptions, whether or not appellant was allowed to keep the added charges (R. 85). The Commission's

original decision (R. 46) merely provided that the amounts collected be set up in a separate account and that "on motion of the Commission or upon application of the Company, other disposition of the accrued balance might be made as conditions warranted." The Commission's second decision in July, 1942 used similar language (R. 61) and the Commission's second order entered July 15, 1942 *for the first time* used the language that the additional charges "shall not be taken into the income account until such time as the Commission may authorize such action" (R. 64).

Appellee's brief disposes of the cases cited in our brief illustrating receipts under a restriction (Appellant's Brief 31-35) merely by saying that they are not in point (Appellee's Brief, footnote 2, p. 25). These cases are in point to the extent that each of them dealt with the receipt of funds subject to a restriction, which is the issue in this case. None of the cases cited by appellee in its brief (18-39) deal with funds received subject to a restriction, except the *Brooklyn Union Gas* case and *Agne v. United States, supra.* In all of the other cases there were no limitations whatever on the taxpayer's right to use the funds as it saw fit and no requirements by regulatory bodies or others that an equivalent amount be held available at all times.

Appellee's brief cites cases for a number of propositions to which we have already agreed, i.e., the possibility that money received will subsequently have to be repaid is not sufficient to keep it out of income

in the year received (Appellee's Brief 23, 29, 30, 34, 35, 38; Appellant's Brief 29-30); the fact that the system of annual accounting is necessary for the collection of income taxes (Appellee's Brief 30-35; Appellant's Brief 42-43); the fact that *North American Oil Consolidated v. Burnet* is still law (Appellee's Brief 35-39; Appellant's Brief 16, 29). There being no dispute on these points, we see no reason to discuss these cases in this reply brief.

We are not clear from the discussion in appellee's brief beginning with the last paragraph on page 30 whether appellee is asserting that under the annual accounting principle and under Sections 41 and 42 of the Internal Revenue Code, it is necessary to allocate the increased charges in this case to 1941 and 1942 even though they may have been received subject to restriction and not held subject to appellant's unfettered command. Such a contention we consider demonstrably unsound because it flies in the teeth of the language used by the court in *North American Oil Consolidated v. Burnet* (quoted pp. 16-17 Appellant's Brief and pp. 33-34 Appellee's Brief), a case otherwise relied on repeatedly in appellee's brief (23, 33, 36-39), and in the earlier case of *Corliss v. Bowers, supra,* (see discussion our brief 16-20, 42-43). Funds received under a claim of right *and without restriction as to their disposition* are income in the taxable year received by the taxpayer, but funds received *subject to a restriction* are not income until the restriction is removed (*North American Oil Con-*

solidated v. Burnet, Corliss v. Bowers, and cases cited pp. 31-35 our brief). *Burnet v. Sanford & Brooks Co.,* 282 U.S. 359, relied on by appellee to support the annual return principle came *before North American Oil Consolidated v. Burnet* and cannot be said to qualify it. The pertinent language in Sections 41 and 42 of the Internal Revenue Code has been in corresponding sections of the Income Tax Acts for many years and Sections 41 and 42 were in the law when Justice Brandeis delivered his opinion in *North American Oil Consolidated v. Burnet.*

Since items received under a restriction are not gross income until the restriction is removed, the annual accounting theory and Sections 41 and 42 cannot be applied until that time. Another analysis leading to the same result is that a taxpayer on the accrual basis (as is appellant—R. 27) cannot accrue income until the *right* to receive it becomes fixed and definite irrespective of the time when the money is actually received. *Spring City Foundry Co. v. Comm'r,* 292 U.S. 182, 184 (1934). The right to money received subject to a restriction does not become fixed and definite until the restriction is removed and it is improper to *accrue* the item as income prior to that time. It should be noted that the Treasury Regulations themselves recognize that the absence of a restriction is necessary to permit an item to be classified as gross income. Regulations 111, Section 29.41-2 state in part: "A taxpayer is deemed to have received items of gross income which have been credited to or set apart for him *without restriction*" (italics supplied) (Appendix, *infra*).

II. THE INCREASED INSTALLATION AND NEW SUPERSEDURE CHARGES ARE NOT TAXABLE INCOME TO APPELLANT IN 1941 AND 1942, OR IN ANY OTHER YEARS, BECAUSE THEY DO NOT CONSTITUTE "INCOME" WITHIN THE MEANING OF THE SIXTEENTH AMENDMENT.

Appellee, somewhat heatedly, rejects our contention that the increased installation and supersedure charges are similar to subscribers' contributions for line extensions (which are not taxed as income) and thus are not includable in appellant's taxable income (Appellee's Brief 39, 40). Appellee's reasons for urging that the increased installation and supersedure charges are *not* similar to contributions for line extensions are set forth on page 43 of its brief and are as follows:

1. The increased charges were *earned* by appellant's services rendered to subscribers during the taxable years involved and in earning the additional revenue, appellant employed both capital and labor. But we have pointed out (Appellant's Brief, 49) that the Cuba Railroad Company in *Edwards v. Cuba Railroad,* 268 U.S. 628, likewise had to "earn" the subsidy by building the railroad line and expending its capital and labor. Similarly, in many of the line extension and spur track cases cited in our opening brief (45) the taxpayer had to build the line or track by utilizing its capital and labor to become entitled to the contribution. Therefore, these factors cannot be considered significant in determining whether payments of this sort are taxable income.

2. The Commission's decision shows that the increased revenues were not to be treated as part of appellant's invested capital, as were the contributions,

donations or subsidies in *Brown Shoe Co. v. Comm'r,* 339 U.S. 583, *Texas & P. Ry. Co. v. United States,* 286 U.S. 285, and *Edwards v. Cuba Railroad, supra.* But we have shown that it is not necessary for payments of this nature to be treated as part of the taxpayer's invested capital or be earmarked for or applied specifically against capital improvements (Appellant's Brief, 50). What difference does it make that the payments are denominated "contributions to capital" if they can in fact be used by the taxpayer for any purpose? *Texas & P. Ry. Co., supra,* distinguishes *Edwards v. Cuba Railroad* on the ground that in the latter case the payments were conditioned upon construction work performed (286 U.S. 289, 290). So, in our case the increased revenues were dependent upon installing and connecting instruments, part of which work constituted a capital expenditure (R. 25).

Our reasons for stating that the additional installation charges are similar to contributions for line extensions are that both are payments made by appellant's subscribers for the installation or connection of telephone facilities rather than for ordinary telephone service and that both are "windfalls" to appellant. In the former case the subscriber builds an extension and gives it to appellant or reimburses appellant for building it; in the latter case appellant receives an extra payment to which it is not entitled as ordinary revenue (R. 45) and does not perform any work or services (except billing and accounting) in addition to those it would have to perform anyway (R. 26-27).

The additional charges were not intended as a supplement to or substitute for regular income as in *Texas & P. Ry. Co. v. United States, supra,* and *Helvering v. Claiborne-Annapolis Ferry Co.,* 93 F. (2d) 875. When the additional charges were received in 1941 and 1942 they were required to be placed in a particular fund or account and, thus, were not like the unrestricted payments to the taxpayers in *Baboquivari Cattle Co. v. Comm'r, supra,* and *Lykes Bros. S.S. Co. v. Comm'r, supra.*

CONCLUSION.

For the reasons stated in our opening brief and in this reply brief, the increased installation and new supersedure charges were *not* taxable income to appellant in 1941 and 1942 and the judgment of the District Court, below, was erroneous and should be reversed and that Court directed to enter judgment for appellant accordingly.

Respectfully submitted,

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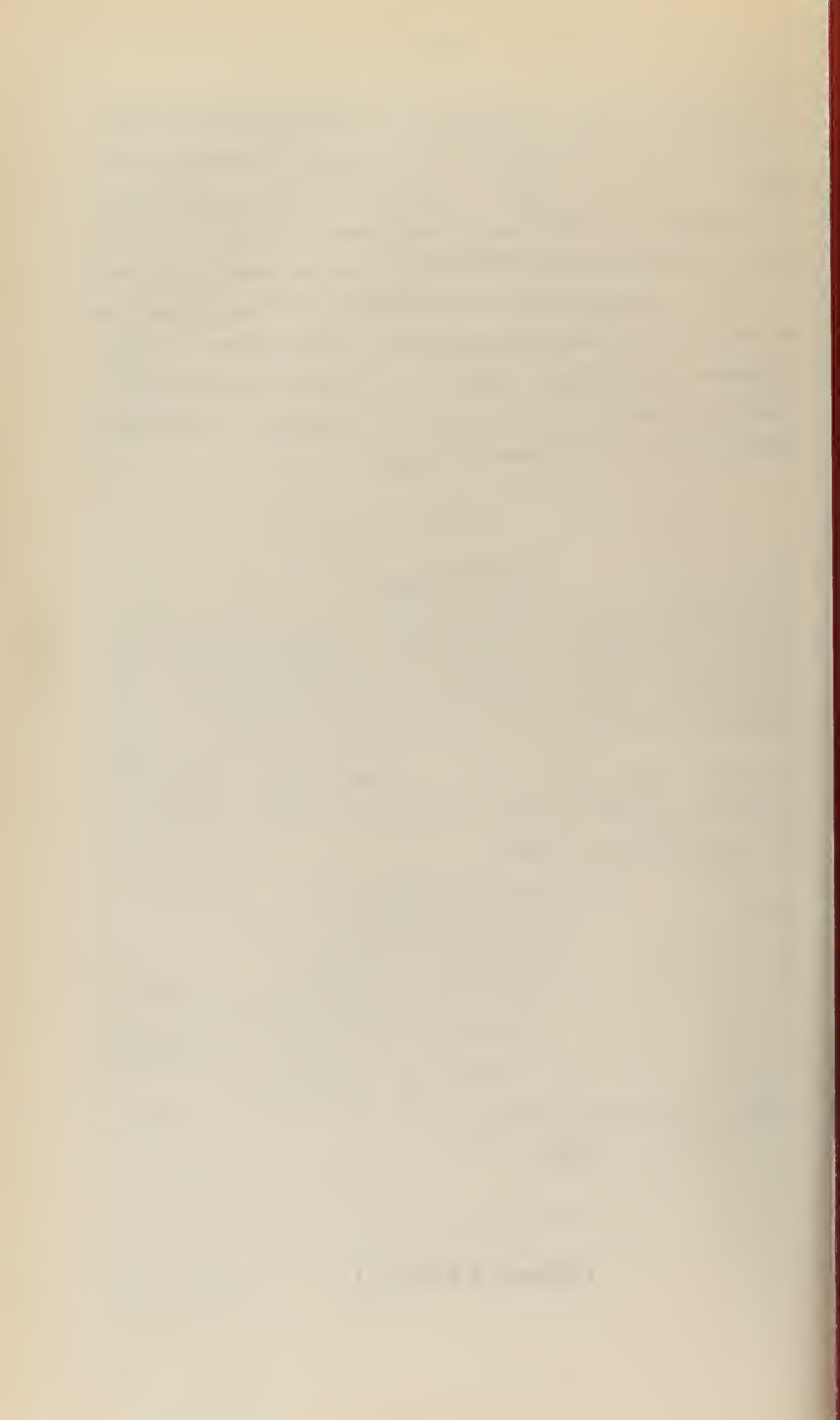
(Appendix Follows.)



Appendix.

Appendix

Treasury Regulations 111

"*Sec. 29.41-2. Bases of computation and changes in accounting methods.*—Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. See section 48 for definitions of 'paid or accrued' and 'paid or incurred'. All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. But see sections 42 and 43. See also section 48. For instance, in any case in which it is necessary to use an inventory, no method of accounting in regard to purchases and sales will correctly reflect income except an accrual method. A taxpayer is deemed to have received items of gross income which have been credited to or set apart for him without restriction. (See sections 29.42-2 and 29.42-3.) On the other hand, appreciation in value of property is not even an accrual of income to a taxpayer prior to the realization of such appreciation through sale or conversion of the property. (But see section 29.22(c)-5.)

* * *"

(The above quoted provision is identical with the corresponding provision of Section 19.41-2 of Treasury Regulations 103.)